



## Varig case: The downfall of a Brazilian icon

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### *Abstract*

**Purpose:** This article aims to examine the reasons of strategic nature that led Varig, the traditional 80 year-old Brazilian flag carrier, to a decadence process, which, in 2006, put a doubt over the continuity of its operations.

**Design/methodology/approach:** To accomplish to this purpose the case study investigative methodology was applied and official sources were consulted, such as annual reports, previous studies and electronic documents at Civil Aviation Department. In parallel, direct observation was also used, which was possible because at the time the authors were executives of GOL, which was another Brazilian airline.

**Findings:** The main reasons identified were the environmental change occurred in the international and domestic scenarios, increasing sector competition; the peculiarities of its corporate governance; and the internal contradictions and its lack of capability to react to environmental changes.

**Originality/value:** No other studies covering the decadence and the last days of Varig had been written before and the fulfillment of this gap may be useful to understand why and how apparently invulnerable traditional and prestigious airlines can perish.

**Keywords:** Air transport, environmental changes, corporate governance, organizational inflexibility, organizational change

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## 1. Introduction

There are a great number of definitions about the signifying of the corporate strategy concept. However, in the middle of such a huge diversity of approaches, there is a converging aspect: dealing with strategy implies, among other aspects, in treating the adjustment between the organization and its environment. Certo, Peter, Marcondes and Roux (2005) define strategic administration as being "the continuous and interactive process that aims to keep an organization as a unit properly integrated in its environment. Thus, disarticulation taking place between the organization and its environment brings a strategic disarrangement in its fundamentals. It brings a disharmony process, reaching a great part of its functions, which, depending on its level and permanence, ends up in its complete collapse.

This case study is about a great organization, with 80 years of existence, with human resources that have a large experience, with huge prestige inside and outside Brazil, and counts on the sympathy from government and from general public. This organizational profile of apparent invulnerability was in radical discrepancy with its pre-bankruptcy situation, lived in mid 2006. This article will examine the structural reasons that led Varig to this contradictory situation.

## 2. Methodology

According to Yin (2003), case studies are an adequate methodological strategy when the investigative hypotheses are related to questions like "how?" and "why?" and when contemporaneous events are focused. On the other hand, still per Yin, investigative strategies can be either exploratory, or descriptive or explanative. Thus, by combining the two propositions with the specific hypotheses of this case study, mentioned below, one can classify the present essay as being an exploratory case study.

As for the method of collecting evidences, the following sources were used: documentation, represented by annual reports, previous studies and consultation of electronic documents at Civil Aviation Department; and direct observation of the

behavior of the protagonists of the studied events. Also three principles of collection of data, as suggested by Yin, were observed: use of multiple sources of evidences, creation of a database about the subject and establishment of an evidence chain.

The hypotheses accepted here as being the main reasons for Varig's decadence process are:

- Changes taking place in the macro-economical and in the industry, bringing a deep adaptation disarrangement in the organization in regard to its environment
- Peculiarities in the corporate governance of the company, making the change process establish a conflict between the expectations from internal and external public
- Not overcoming the conflict of interests between such publics, in conjunction with the past of great achievements, that led the company to a situation of big strategic, tactical and operational inflexibility

As pointed out by Drucker (1986), the economical environment is not changing, it has already changed. The capability to notice environmental changes movements, which is a *sine qua non* condition for the organizational change, has to be a part of one company's competences. Later on, this capability will be examined among Varig's abilities, when it was hit, in the end of the 90s, by changes already happened in the end of the 70s.

According to Kaplan and Norton (2001), the experience has shown that the most important isolated condition for the process of change is the active commitment of the executive leadership of the organization. This peculiarity, too, will be explored in Varig, taking into consideration the power relationships existing in the organization.

Previous achievements are, according to Hitt et al. (2002), a source of inflexibility in performing changes because the organization tends to answer to the new challenges with the same formulas that were successful in the past. Along this text, one will examine in which measure the previous unquestionable successes, cumulated by Varig during its history, were elements that made difficult the implementation of changes.

At last, it will be made explicit whether or not the balance of reaching aspirations from different stake-holders, so necessary for achieving the organizational stability, according to Hitt et al. (2002), was in Varig's fall process.

### **3. Historical facts (1927 to 1997)**

Founded on May 7, 1927, S.A. Empresa de Viação Aérea Rio-Grandense was the first air transport company in Brazil and one of the first in the world. Its origins go back to 1921, when its founder and first chairman, the German Otto Ernst Meyer, came to Brazil. When it was beginning its activities, the company was supported by Kondor Syndikat, a German airline, with its headquarters in Berlin.

During the Second World War, while the Brazilian airlines were facing difficulties due to the lack of spare parts for its European airplanes, Varig renewed its fleet with North American airplanes: Lockheed 10 Electra.

In the year 1942 was launched the Porto Alegre – Montevideo line, introducing Varig to the international scene. After that, with the War end and the change in the political panorama that was valid until then, Varig, now under command of Ruben Berta, expanded its fleet with Douglas DC-3/C-47 remaining from the War. It began, thus, its international expansion.

In the beginning of the 50s, with the low price availability of great number of aircraft remaining from War, the barriers to the entry in the industry were considerably low. As a consequence, the sector now had a significant fragmentation, and several small regional companies arose.

Like the other companies, that would come to have full size operation in the following decades, also Varig initiated an expansion process, which was strongly founded on the acquisition of smaller airlines.

In 1951, Varig bought Aero-Geral and started its domestic links to the northern region of the Country. Until then, its operations were concentrated in the regions South and Southeast. The international expansion kept on with its extension of the Montevideo flight over to Buenos Aires and intensified itself with the new Lockheed Super G Constellation just arrived, that allowed the company to fly to New York. By the end of this decade, Varig became a pioneer in the jet flight operation in Brazil, with the purchase of the Sud Aviation Caravelle and Boeing 707. Scale gains due to

the fleet growth and to the new aircraft efficiency gave a great impulse to the company's profitability.

Varig kept on with its growth both domestically and internationally, still based on the strategy of acquisition and incorporation of other companies, such as Consórcio Real Aerovias and Panair do Brasil, which had been during decades its main competitors. With the purchase of Real airline, Varig started operating lines to almost all of Brazil and also to Miami, Caracas, Lima, Bogota, Mexico, Los Angeles and Tokyo. With the acquisition of the Panair's routes, then Varig started flying to Europe (Lisbon, Madrid, Paris, London, Frankfurt, Milan and Rome). The new destinations would be now operated with Boeing 707 in a first moment, and after that, with the wide bodies (Douglas DC-10-30, A300, MD-11, Boeing 767, Boeing 747 and, most recently, Boeing 777).

In the 70s, Ruben Berta Foundation (2002) bought the share control of Cruzeiro, which came to be the first step for its complete acquisition, and that would happen 17 years later. Still in the 70s, the Foundation creates the regional airline Rio-Sul to operate in the recently implemented Sistema Integrado de Transporte Aéreo Regional – SITAR (Integrated System of Regional Air Transport). For one to have an idea of magnitude of Varig in 1977, the company had about 15 thousand employees and operated in 31 Brazilian cities and 26 abroad, being the biggest international network ever operated by a Latin American airline.

The economical plan called "Cruzado" (plan for macroeconomic stability, implemented by the Brazilian Federal Government in 1986) marked the begin of the company's crisis, when it froze the air ticket prices sold in Brazil, but did not freeze the operational costs, that kept on going up. The situation got worse when the ex-President Fernando Collor de Mello opened to other Brazilian airlines the commercial aviation market on the international routes. From this moment on, Vasp and Transbrasil became competitors to Varig on these routes. The Government allowed, too, by means of bilateral agreements expansion, the entry of new foreigner airlines that started to fight over the international market, operating with lower costs and lower fares. Varig started to present systematic and growing losses from the year 1998 on.

In 1996, when it modernized its visual trademark, the company abandoned a communication style that was one of the most representatives and enduring ones in the commercial aviation around the world. This step, more than an update to its brand, marked the beginning of tentatively readjust the company to the new

competitive reality of the industry both in Brazil and in the world. By ends of 1997, despite of its entry in the Star Alliance – strategic cooperation alliance gathering other 14 great international companies, such as United Airlines, ANA – All Nippon Airways, Lufthansa, SAS – Scandinavian Airlines, Singapore and Thai – gets deeper the process of financial crisis, bringing its fleet reduction (devolution of Boeing 747s) and layover of employees. International routes were cancelled, one after the other, in a moment when competitors were expanding.

Varig's acceptance by Star Alliance symbolized the recognition by a part of the global industry of commercial aviation of the relevance of Varig in the international context, marking the company's participation in a "club" of high reputation companies. Thus, the entry in Star Alliance marked the last strategic advancement by Varig. Since then, all strategic actions of the company would be of defense nature, i.e., aiming only its survival.

#### **4. The crisis aggravation (1998 to 2005)**

In 1998, the atmosphere was optimistic at Varig, but the reality of the years to follow frustrated the expectations. The exchange rate crisis in 1999 provoked a remarkable fall in demand of the international routes and aggravated the company's debts that usually gathered resources from the international finance market. The negative impacts in its results left Varig weakened for the next years, while Tam would become its main competitor and Gol would start in the market, making competition even more difficult in the domestic market.

In a deep finance crisis moment, in December 2002, with a cumulative loss up to September of R\$ 2 Billion, Varig postponed the payment of the 13<sup>th</sup> salary to its employees, for the first time in its history. The reason stated for that was the need to make daily payments to the State owned BR oil distributor, in order to maintain the fuel of its aircraft in Brazil. Simultaneously, in Paris, one of its aircraft was kept on the airport due to lack of leasing payment, which called attention of Brazilian Government for the severity of the company's situation.

The next year began with the signature of a memorandum of understanding for the fusion of Varig with its main competitor, Tam, that also lived a finance crisis moment. According to this agreement, sponsored by the Brazilian Government, both companies initiated a fusion process by making a codeshare in part of their domestic flights. This joint operation got to cover more than half of the flights of

the companies and it made Tam come over Varig in number of passengers transported in the domestic market.

In that occasion, SEAE – Secretaria de Acompanhamento Econômico do Governo Federal (Federal government's secretary for economic monitoring) recommended to CADE – Conselho Administrativo de Defesa Econômica (administrative council of economic defense) the suspension of the codeshare agreement, stating damage to the consumers, given that the codeshare meant, in praxis, supply shrinkage, restricting the competition and bringing along the increase of fares. After months of codeshare operation, the so intended fusion, however, would never come to happen.

Among the elements that inhibited Varig-Tam fusion was the fact that this process initiative was purely governmental, without any real interest from any of the companies, for this being effective. Tam was afraid that Varig's liabilities would lead to its inviability (due to its magnitude), while Varig awaited that a governmental action would rescue it from its difficult situation, without having to touch its internal structures.

In 2005, Varig and Tam announced the end to their codeshare agreement, which made Varig cancel part of its routes, being then overcome by GOL in its domestic market share in April that same year.

With the crisis aggravation, the company requested to the Brazilian Justice in order to have a process or judicial recovering, a mechanism that would replace the Chapter 11, according to the new Bankruptcy Law in Brazil. Simultaneously, Varig started a negotiation with Tap (from Portugal), for selling the company, which would purchase its subsidiaries Varig Log (cargo) and VEM (aircraft maintenance). With the result of this sale, Varig had a relief for a moment of the pressure on its cash flow. However, a few months later, the pre-bankruptcy situation of the company would come again.

## **5. The environmental changes impacting Varig**

### **The fares freeze**

In the political and legal environment, the main change negatively impacting Varig was the freeze of the air fares, happened due to the edition of the national macro-economic stability plans, between 1986 and 1991. The credits from the judicial

action entered by Varig against the Union of States of Brazil, trying to have back the losses caused by the fares freeze, together with its taxation paid to the State and Federal governments, recognized by the company in its finance results books as per research on December 31, 2005, got to the mark of R\$ 7.03 Billion. On the other hand, in these very same books, the liabilities uncovered by the company reached the mark of R\$ 7,09 Billion, remaining, thus, an adjusted uncovered liability of R\$ 890 Million.

From another point of view, Varig accumulated taxation debts of R\$ 3.5 Billion up to December 31, 2005. Having credits and debts unpayable to the Federal Government, Varig's intention was to make a clearance of accounts, in order to clean up its balance sheet and allow the search for resources capable of making viable its operation in a short term.

The big problem was that, even making all this cleaning action, Varig was enduring in the performance of high operational losses, which inhibited any type of capitalization.

However, other environmental changes, happened in the sector environment, impacted very toughly the company. The main ones are: review of the bilateral agreement between Brazil and USA, since 1989, increasing the number of frequencies between both Countries, expanding the number of companies designated and establishing a bigger flexibility of fares offered in this market; and the freedom given by the Federal Government for the Brazilian domestic air fares and the facilitation of new players in the sector, which, in last analysis, made viable the implementation and development of GOL.

The reviews of the bilateral agreement Brazil – United States of America

In 1978, President Jimmy Carter bestowed the Air Deregulation Act, in the United States. Since then, the U.S. Government made efforts to implement the Open Skies Policy, i.e., liberalization of the air transport activity.

In order to adjust to the new U.S. institutional mark, there was the need to review the Air Service Agreement (ASA) between Brazil and U.S., mostly in regard of the designation and capacity questions. The bilateral agreement covered the monodesignation, i.e., restricted to each Party the designation of just one company to operate between the two countries. This enabled only Varig and Panam to



explore this market for decades, the first representing the Brazilian flagship and the second one representing the U.S.

In order to push the Brazilian Government, the U.S. Government denounced in 1981 the existing bilateral agreement. However, only on March 21, 1989, i.e., eight years later, Brazil and U.S. signed a new Air Services Agreement, now covering the multi-designation, increasing to three the number of companies enabled to fly on each country's behalf.

As for the capacity, i.e., number of frequencies agreed by each Party, the new Air Services Agreement determined that, since 1<sup>st</sup> of April 1989, the designated airlines from each country would be able to operate 29 weekly frequencies on each side. The number of frequencies agreed would increase to 31 on April 1<sup>st</sup>, 1990; to 34 on November 1<sup>st</sup> 1990; and to 40 on April 1<sup>st</sup>, 1991. The U.S. airlines Eastern Airlines and American Airlines started then services to Brazil, at the side of Panam.

The Brazilian governmental policy for the international air transport was the one of the mono-designation, independent upon what was covered in the bilateral agreements between other countries. In practical life, this orientation implied that Varig had a monopole for the Brazilian part of the international markets. This situation brought along an enduring and continuous pressure by the other Brazilian airlines, that wished to have income in strong currency, so needed in the Brazilian economic environment of chronic and high inflation.

The flexibilization process of the mono-designation policy of the airlines corresponded to the political opening and end of the dictatorship regime lived in Brazil. Thus, the National Civil Aviation Conference (a non regular period based event, involving the aeronautical authority and airlines in Brazil, organized whenever there is a need to reformulate the sector policy in Brazil), held in 1986, started the opening process for the international routes, by allowing the operation of other Brazilian airlines on non regular scheduled flights to abroad. The directions formulated in the conclusions of this conference pointed to a future market opening for regularly scheduled flights, which, in fact, happened in 1991, with the entry of Transbrasil and Vasp in the long-haul international market.

In the 90s, the aeronautical consultancy meetings between Brazil and the U.S. became more often. Given this, the capacity was expanded up to 105 weekly frequencies, agreed in November 1997. Moreover, the number of designated

companies on each side increased to 4, which made possible the entry of Tam and Continental Airlines, from the Brazilian and the U.S. side, respectively.

There are the ones who consider that the Brazilian Government would have expanded too much this bilateral agreement with the U.S. and would have allowed the entry of too many competitors on these routes that were, until then, reserved to Varig and to the designated company from the U.S. In fact, the impact of these measures was huge and contributed to the disarticulation of Varig. Nevertheless, according to Brigadier Carlos Sérgio de Sant'anna César, who was the president of the Consultancy Meeting Brazil – United States in 1991, the estimates of traffic increment made at that time indicated an exponential growth of demand. The forecasts considered data of passengers transported from 1989 through 1995, period in which the traffic had grown 225%.

Based on this expectation of demand growth, the Brazilian airlines requested, according to Brigadier César, a number “corresponding to 149 weekly frequencies, being, thus, conservative the position of the Brazilian government when it agreed upon only 105 weekly frequencies”. However, the traffic between Brazil and the U.S. from 1998 through 2004 kept practically the same.

Before the significant reversion of the previous expectation, the conservative positions of the bilateral agreement Brazil – United States became inoffensive, building barriers to the entry and leading, in praxis, the specific market to the free competition model. In other words, the political changes had set Varig, in its main international market, in a very hostile environment.

### **Flexibilization of domestic air fares in Brazil**

The begin of flexibilization process of the domestic air fares in Brazil occurred in 1992 by means of publishing the Regulatory Order (portaria) nº 075/GM5, of February 6 of that year, after complemented by the Orders nº 1632/DGAC of December 9, 2003 and nº 1282 of December 2004, following the world trend that one could see in the sector. This trend began in the U.S. by means of the edition of the Air Deregulation Act, mentioned before. In Western Europe, the deregulation occurred in a slower process, between 1987 and 1997, by means of three acts edited by the Council of Europe Regulations.

These legal diplomas fixed criteria of determination of fares and limits both maximum and minimum for these amounts. These limits were created based on the

curve of costs (distance versus unit operational costs) of the main equipment used in the operation of the domestic flights of that time, Boeing 737/300. The intention was to introduce a certain grade of competition based on the sector's fare, avoiding from extreme situations, not only in regard of the exaggerated high fares, but also in regard of the too low fares that could possibly bring a risk to the sector profitability.

The dynamic competition and the unit costs relatively close to each other among the competitors ended up making the maximum and minimum limits very difficult to reach, at least up to the moment when GOL launched.

Thus, since 2001, supported by unit costs that were inferior to the industry average, between 25% and 30%, and by using exhaustively the yield management techniques, GOL started coming down frequently to the minimum allowed prices established and, in many cases, under special approvals, even lower than the minimum.

Differently from what the traditional competitors were expecting, GOL's marketing mix, supported on the binomial low cost – low fare, had an enormous acceptance by the public, obliging the industry, as a whole, to reduce significantly their average prices. The more GOL grew, the more the competition to Varig grew and, in a few months, there was no relevant market whose prices had not been significantly reduced.

On the international field, the trend of fares liberalization was getting intense and the general practice was that of the complete freedom, when the trade of travel occurred in foreigner countries. On the other hand, the trade of international travel within Brazil obeyed to very restrictive values and fare rules, established based on IATA's criteria (International Air Transport Association). Even if so, the Brazilian governmental inspection inhibiting the prices lower than the minimum established was left behind by means of disguised discounts, given by the airlines to the travel agents, sales channels highly predominant in the sector.

In a few words, in the praxis there were just a little effective mechanisms of governmental control related to the sales of air tickets at low prices. However, the support from the Brazilian Aeronautical Authority to forum, such as to JURCAIB – Junta das Companhias Aéreas Internacionais no Brasil (joint of international airlines in Brazil), created mechanisms of self control in the industry.

In regard to the air cargo, not only domestic but also international, free competition of prices was practically total. The fundamental reason is that, even if there was an index table of fares published by the Brazilian Government, the diversity of nature and variation of cargos, for which there are specific and different fares, it becomes virtually impossible to implement any type of price control.

In summary, the deep environmental changes felt in a more intense way by Varig since 1998, in fact have their origins 20 years earlier, without any change process taking place within the company, as one can see ahead.

Probably, the period of time past between the environmental change and the manifest of its effects was so long due to the solid institutional machine built in the symbiotic relationship between Varig and the Federal Government.

## **6. Peculiarities in Varig's corporate governance**

The share composition of Varig is *sui generis*, once its absolute control is kept by a philanthropic entity named Ruben Berta Foundation, although it has its shares commercialized in stock exchanges.

Before 1996, Varig's share control was held by an employees' foundation of the company, which changed its name to Ruben Berta Foundation, in honor of its former chairman.

The mission statement of the entity brings this: "To promote the well-being of its employees by taking actions oriented to quality of life, constituting a motivational and commitment element together with the Entity and the company for which they work". This mission (sic) is explicit in the first article of the Statute of the Foundation, which constitutes its stone clause: "... is meant to ensure well-being of Varig's employees and its dependants, according to the merit and years of work of those ones...". This first paragraph of the Statute includes among the beneficiaries also the permanents of the Foundation itself and the fourth paragraph includes retired and children under 18.

As one can deduct, since its creation, Ruben Berta Foundation was imagined as an Entity with the prime purpose of benefiting its members, not including any other stakeholder in its explicit preoccupations, not even in its corporate rhetoric. Moreover, this is about a fundamental and confirmed position and along its existence.

The Foundation Social Statute (sic) established the creation of a Council (highest instance), made of **employees with more than 10 years in that company. Currently there are 220 members** (authors' remark). They would be responsible for the decisions that would guide the future of this institution.

Thus, besides an institution concerned about itself, the foundation is led by a kind of internal aristocracy, whose premise of participation is seniority in the organization.

As one can observe, the values and postulates of the Ruben Berta Foundation constitute completely unusual characteristics in modern organizations as well as unlinked to the external environment demands. In other words, the entity's fundamental characteristics confront explicitly against the strategic approach previously enunciated.

In this context, it is easy to imagine in which measure the internal leaderships of the organization were much more committed with the objectives of these groups than to its alignment with external demands of change.

## **7. The internal contradictions and the incapability to react to environmental changes**

Paradoxically, Varig's corporate speech was to associate, domestically, its own interest with the sector's interest and, internationally its own interest with the Brazilian Government's interest. It is easy to evaluate how this rhetoric was always well accepted by Brazilian Authorities, responsible for the governmental policies for a controlled industry, exploring a public service (as it has always been defined in Brazilian constitutions), linked to a military Ministry, with many years under dictatorial governments. Shamefully, in the industry slang, one uses to say that "Brazilian team (of soccer) is the Homeland in soccer shoes whereas Varig is the Homeland on wings.

It is surprising that this contradiction – mission oriented to internal interest and rhetoric oriented to national interest – never has been explored by dissociated interests from the ones of Varig.

On the other hand, the remarkable adjustment between corporate rhetoric and the political-military ideology along several years constituted essential competence in the organization, responsible for most of Varig's successful achievements, even

because international commercial aviation is ruled by bilateral and multilateral agreements among the countries.

Although this speech has been losing strength since civil democratic governments took over Brazil, getting to the point of passing by indifference, according to this text's epigraph, it has been reinforced by the enormous corporate success of Varig. As Hitt et al. (2002) emphasizes, organizational inflexibilities can originate from old strategic competences that became obsolete.

This case's authors' personal examination of the repetitive demonstrations of Varig's important employees, in the sense that the Brazilian Government would not allow this company to go bankruptcy, added to the success lived by the organization during years, show that the organizational inflexibilities mentioned by Hitt et al. (2002) are, in fact, one of the fundamental causes of Varig's decadence.

One can say so, because while the competitor Tam, in the beginning of 2000s, was modernizing its commercial systems, reducing costs, changing its price tactics in order to face the new competitive environment, Varig kept itself stuck before the aggravation of its difficulties, waiting for the redemption to come from its traditional ally, the Federal Government.

In regard of the adjustment of its operations to a more competitive environment, arising from a smaller governmental intervention in the sector, Varig took no important structural action to adjust its operational costs to the new demands. Evidently, this lack of action is related to its genuine organization's commitment in defending inflexibly its employees' interests, which almost invariably are contradicted in the downsizing and downscoping processes. This is not about the layovers inherent to those processes, but also the more demanding work practices, such as more monthly working hours of the crew, just to mention one example.

## **8. Conclusion**

As showed, the environmental changes occurred in the air transport industry, a process that began in 1978, in the U.S., transformed structurally the sector, determining that the airlines reduced its costs and started having more competitiveness, as a *sine qua non* condition for their survival. These changes impacted directly Varig, a company led by an aristocracy of employees and committed with the internal needs and, therefore, disarticulated in the external environment demands.

It became also clear that Varig's survival would be possible if the organization had implemented changes processes, such as other airlines did in Brazil and around the world.

It was pointed, too, that performing essential adjustments to the organization's survival would collide with Varig's employees' interests, generating an unovercomable contradiction.

In this environment, the belief flourished that the redemption would come from outside, from the Brazilian State, in a kind of corporate sebastianism, in which everything would change for better without that anyone would have to touch any sensitive point of the employees' interest.

On the other hand, the organization's expressive successful achievements, reached in a not so far away past, reinforced the company leaders' conviction that their organizational model was the most efficient, even being denied as a belief by the external environment.

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